

Internal Revenue Service
memorandum

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Br3:ELBerkowitz

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to: James Stockton
International Examiner NA:BUF:R

from: Bernard Bress
Senior Technical Reviewer CC:INTL:Br3

BBS

subject: [REDACTED] - [REDACTED] Foreign Currency Exchange Gain

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This is in response to your request for informal technical assistance in the above referenced matter.

ISSUE:

Did [REDACTED] correctly record the transaction when it capitalized a portion of a note receivable to its wholly-owned German subsidiary, [REDACTED]?

FACTS:

In [REDACTED], a corporation with the U.S. dollar as its functional currency, made a contribution to the capital of its wholly-owned German subsidiary, [REDACTED].

The contribution consisted of capitalizing a portion of a [REDACTED] deutschmark demand note that [REDACTED] had previously made to [REDACTED], in the amount of [REDACTED] deutschmarks. [REDACTED]'s functional currency is the deutschmark.

[REDACTED]'s basis in the [REDACTED] deutschmark portion of the demand note was \$ [REDACTED] and when the contribution was made, the fair market value of the [REDACTED] deutschmarks was \$ [REDACTED].

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█████ characterized the partial cancellation as a section 351 non-recognition transaction. Additionally, taxpayer relied on section 108(e)(6), saying that it (█████) did not have to recognize gain on its contribution of the debt to █████. No foreign currency gain was reported.

DISCUSSION:

Section 351(a) prior to October 2, 1989 provided that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such persons are in control of the corporation.^{1/} In order for a contribution by a shareholder to qualify as a section 351 non-recognition transaction, the contribution had to be of "property". Under section 351(d)(2), "property" does not include "indebtedness of the transferee corporation which is not evidenced by a security".

Case law has established that a demand note does not qualify as a security for purposes of section 112 [the predecessor to section 351]. Commissioner v. Sisto Financial Corp., 139 F.2d 253, 254 (2d Cir. 1943); Camp Wolters Enterprises, Inc. v. Commissioner, 22 T.C. 737, 750 (1954), aff'd 230 F.2d 555 (5th Cir.), cert denied, 352 U.S. 826 (1956); Pacific Public Service Company v. Commissioner, 4 T.C. 742, 748 (1945). Since █████ did not transfer a security to █████, the transfer does not qualify as a section 351 non-recognition transaction and gain shall be recognized.

The rules governing the taxation of foreign currency gains and losses are provided for in section 988. Section 988(a)(1) generally provides that any foreign currency exchange gain or loss attributable to a section 988 transaction shall be computed separately and treated as ordinary income or loss. Further, under section 988(a)(3) foreign currency exchange gain or loss is sourced by reference to the residence of the taxpayer. Pursuant to section 988(c)(1)(B)(i), the deutschmark debt instrument issued by █████ is a section 988 transaction with regard to █████. However, since the instrument is issued in the functional currency of █████, it is not a section 988 transaction to such corporation.

Pursuant to Reg. 1.988-2T(b)(5), the holder of a debt instrument realizes exchange gain or loss on the date a debt instrument is disposed of. For purposes of determining whether such gain or loss is recognized, the general recognition rules

¹ Section 351(a) was amended on October 10, 1989 by deleting the words "or securities" after the words "for stock".

of the Code apply.^{2/} Since section 351 does not provide for non-recognition of this debt capitalization (and no other non-recognition section applies), exchange gain or loss will be recognized on the date of the capitalization (since this constitutes a disposition of that portion of the debt for purposes of section 988).

In this case, [REDACTED] will recognize an exchange gain determined by translating the [REDACTED] deutschmark principal amount at the spot rate on the date of capitalization (\$ [REDACTED]) and subtracting the [REDACTED] deutschmark principal amount translated at the spot rate on the issue date (\$ [REDACTED]) for a gain of \$ [REDACTED]. Such gain will be ordinary in character and sourced U.S. (since [REDACTED]'s residence is the U.S.).

Section 108(e)(6)(B) provides that for purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital, such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.

Section 108(e)(6) is irrelevant with respect to determining the exchange gain of [REDACTED] from capitalizing the portion of the debt instrument since [REDACTED] is the creditor and not the debtor.^{3/}

CONCLUSION:

[REDACTED] must recognize gain in the amount of \$ [REDACTED] on the date of capitalization. Such gain is ordinary and will be sourced U.S..

² An exception to this rule is in § 1.988-2T(b)(13) which applies to stock for debt exchanges effected after September 21, 1989.

³ Since [REDACTED] is wholly owned by [REDACTED] [REDACTED]'s basis in [REDACTED]'s stock is increased by the fair market value of the capitalized debt. See Reg. 1.118-1. Therefore, [REDACTED] has no discharge of indebtedness income.